



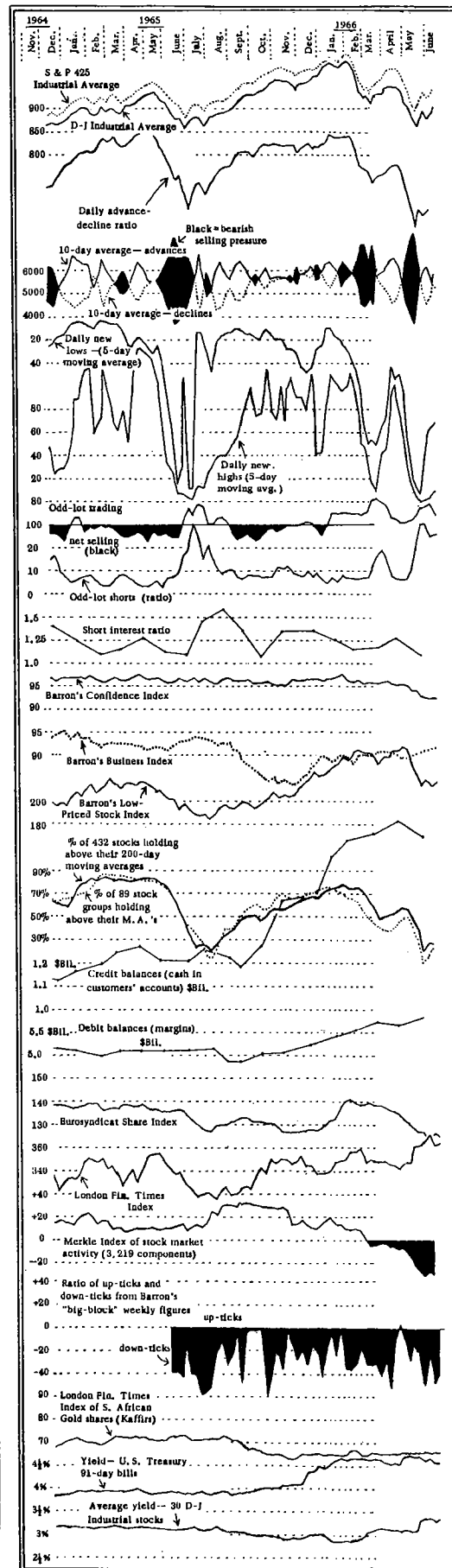
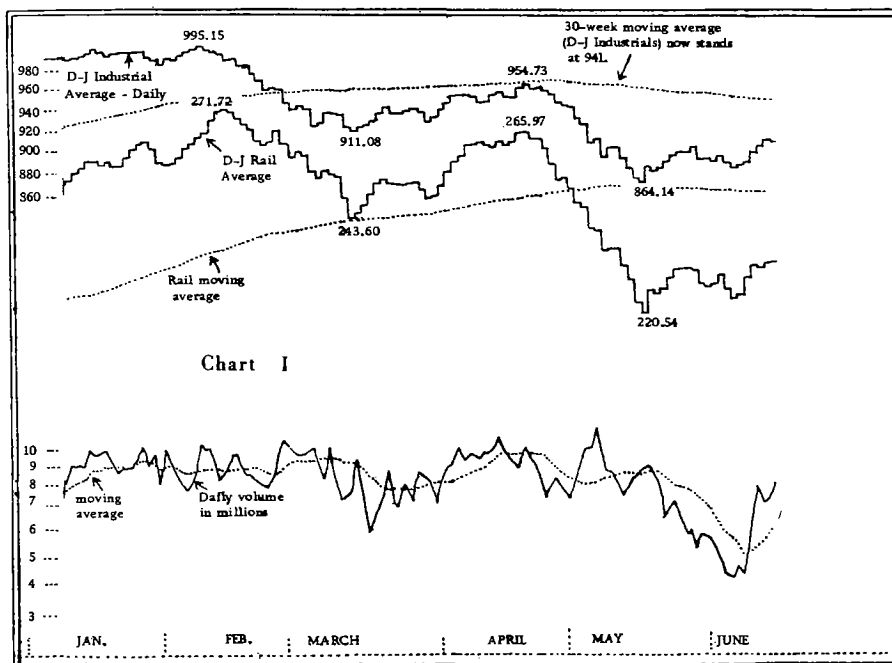
June 16, 1966

Letter 326

THE MARKET: Over any considerable length of time, success in the stock market depends upon following the path of big money, investment money. It is the investment money that makes the primary trend. All through the bull market of 1949-66, it was the big money which led the way. Stocks such as DuPont, General Motors, American Telephone and Texaco represent investment money as do good utility stocks and bonds. This is the reason I have been suggesting to my subscribers that they watch the "class" of the market as represented by this type of investment vehicle. To move against the flow of investment money, sooner or later, means trouble, and I have never seen this principle to fail.

Over the past few months we witnessed a primary bear signal as provided by the Dow Jones Industrial and Rail Averages (May 5), and a few weeks later we saw all four D-J Averages (including the Utilities and 40-Bonds) drop to new lows for the year (Bonds and Utilities sank to their lowest level since 1963). This was not a good omen for the market; it suggested that large investment interests had turned bearish and were getting out. These interests do not make their decisions overnight. They take long-term stands, and once they sell they do not return until stocks and bonds have moved to levels which they consider to be great values.

On May 17 the Industrials and Rails broke to 1966 lows of 864.14 and 220.54 respectively. The market has been in a rallying phase ever since. The question is, should we follow the rally? My answer is that I am not going to follow it. To me, it represents a situation where the speculators and traders have once again taken over and are now "carrying the ball." It appears to me that the speculator has not yet been crushed, and that now, once again, he has regained some of his former strength. He is temporarily "running" the market. But it is not a complete job, and the performance is not convincing to me. Why? Because I note, for instance, that the 40 Bonds closed at a new low this week and that Utilities are at their lows. Many top-grade stocks are not acting



Page 2 well, some are still dropping to new lows, while others are "pulling back" or simply bouncing off their lows as the selling pressure is eased.

I ask myself whether investment money suddenly changed its mind at the May 17 lows, and whether they now think that the fundamentals have changed? I do not believe so. This is simply a case of another rally in what must be considered a continuing primary bear market. Following three months of drastic downside action, the selling pressure has lifted. Sensing this, the speculators have come in again, and the market "appears" to be in a bullish phase again. Many are now talking about a return to and "testing" of the February highs. I do not believe this will happen. I believe that investment interests will utilize this rally as they have used all rallies since February—as an opportunity to distribute more stocks to the speculators and the public. I suggest that my subscribers do the same. If you still have shares, accept this rally as another chance to lighten up and get out before the last sparks of life in the old bull flicker out completely. In my opinion, it is just a matter of time before that occurs. When it does, it will be too late to sell intelligently and unemotionally.

Conclusion: The March-April rally lasted five weeks, carrying Industrials from 911.08 to 954.73. The March-April rally terminated amid wild speculation, new highs in many glamour stocks, and a final high-volume day of 13 million shares. The current rally which started on May 17 at 864.14 on the Dow has now lasted for about four weeks. So far, volume has been less than on the March-April rally, and the moves in some of the glamour stocks have been less spectacular than in March-April. As stated before, I believe that this rally is basically similar to the March-April, and I feel that it could end just as suddenly and unexpectedly.

I warn my subscribers against becoming overly-optimistic while such blue-chip stocks as Allied Chemical, DuPont, Johns-Manville and Standard Oil of California are making fresh 1966 lows (even while the high-flyers are flying). This together with new lows in the Utility and Bond Averages indicates to me that investment money is continuing to walk to the exits. When the current rally ends, we will, in all probability, see another drastic drop in the market.

One factor to watch is for signs of real weakness in the color-TV, Electronic and Airline issues. When these issues finally crumble, there will be no harbor for speculative and gambling money, and the bear market will be on in earnest. I believe that this is the

NOTES & QUOTES: Latest international bank rate rise; Sweden from 5½% to 6% last week. This makes three international rate rises in the past three weeks (including West Germany and Belgium). Of 10 major nations, 6 now have rates higher than the U.S. with U.K., Germany and Sweden all at 6%. Large New York banks are now going after foreign dollars aggressively, and they are selling Certificates of Deposit in Europe.

Major N.Y.C. banks are suffering their tightest money squeeze in recent history. Currently, 74.3% of their total deposits are out on loan, up from 69.9% at the end of 1965. Corporations in general are not faring much better. The ratio of cash and Government securities owned by corporations to current liabilities has dropped to 27%, a record low. This is referred to as the "liquidity ratio," and it measures the relative ability of corporations to meet unforeseen emergencies (at the end of 1965 the liquidity ratio was 30%, at the end of 1962 it was 34%).

This is an excellent time to be off margins of any kind in the stock or bond market. Banks, squeezed for cash, can call in loans outstanding for margins at any time. Margin loans are usually made on a day to day basis, and banks have, so far, been fairly generous about extending margin money. But with money growing increasingly scarce, margin loans could be called, principally because the banks want the cash.

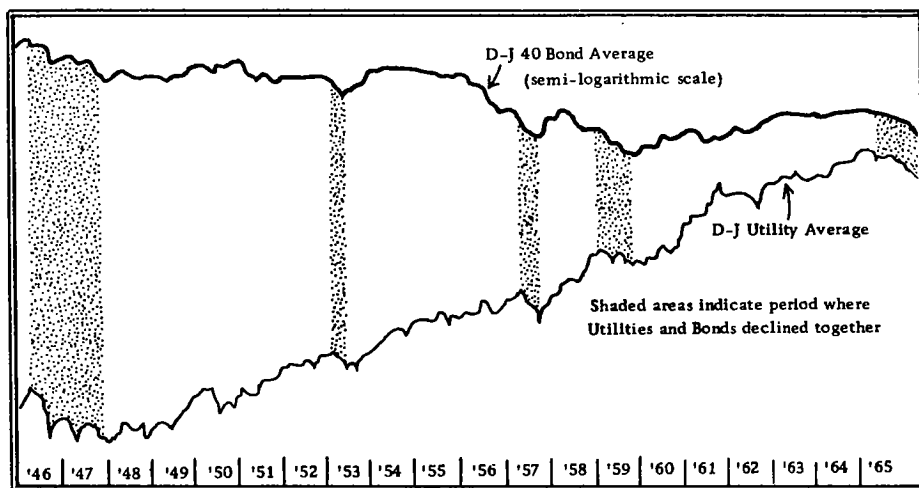
Even the insurance companies are running into the money famine. A number of policy holders are borrowing the cash value of their policies (many insurance companies have a guaranteed ceiling interest rate of 5% on such loans) and then lending the money out at higher rates, thus producing a fool-proof profit.

Here is how the money picture is hitting the California building industry. At the Eighth Annual California Builders' Conference, builders were told that housing starts in the normally booming Southern California area (which has produced over 200,000 starts at times) will drop to around 50,000 starts this year. Builders agreed unanimously that the mortgage market is now the worst they have ever seen. Statistics just in show the value of new construction in San Diego County for May is down 34% from last year, and in Los Angeles it is down 50%!

My friend Harry Schultz (author of "Bear Markets") is so worried about devaluation that he has advised his clients to put around 25% of their capital in hard foreign currencies. He suggests opening an account in one of the big Swiss Banks (Swiss Credit Bank, Swiss Bank Corp.) of Zurich. A cashier's check is sent to Zurich with the request that a new account be opened and the dollars be converted into francs. Government bonds are then purchased (equivalent to our Treasury bills), but the bank should be advised to buy the short-term bonds of Germany, Belgium, Holland or Switzerland (not England). This process will protect you to some extent by providing a profit if devaluation comes. Otherwise, you will simply sit with short-term bonds which pay a high rate of interest.

How does devaluation work? A week ago India devalued by 36.5%. This meant that foreign nations with investments in India saw those investments drop by that percentage in value. Overnight \$1.3 billion worth of rupees held by the U.S. dropped to a value of \$832 million. Thus half a billion dollars in values were wiped out overnight. If you lived in India the cost of foreign goods would immediately jump around 35%. The new U.S. car you were going to buy now looks very expensive, so you try to purchase transportation manufactured in your country. But to the U.S. citizen Indian merchandise looks much more attractive. The dollar will buy 35% more in India than it did yesterday. Finally, it should be remembered that all the American firms who were operating in India and holding assets in rupees have been robbed by 35%. It may take years for them to recover their losses.

From a recent speech in Philadelphia by economist Eliot Janeway: "The most bearish single prospect looming ahead for the stock market is that the cost of Vietnam will force an across-the-boards tax increase after the money squeeze has slowed down the economy and spread significant credit distress, because the money squeeze is responsible for the bearish thrust of the fundamentals, the bond market remains as far away from bottom, despite its sharp decline to date, as the stock market. And the bond market will not be ripe for recovery until the stock market is. Consequently, Vietnam has produced the first war inflation scare in history in which cash is worth more."



type of phenomenon we can expect (perhaps shortly) when this highly speculative upmove exhausts itself.

INVESTMENT FUNDS: Augmenting the previous discussion, I have decided to up-date a chart (page 2) which first appeared in Letter 314. The chart shows the paths of the D-J Utility and Bond Averages since 1946, a period of twenty years. During this span there were only five periods in which both Bonds and Utilities were declining together. These periods corresponded with areas of monetary maladjustments in the economy, and in Letter 314 I stated: "My conclusion is that whenever monetary forces are powerful enough to cause a pronounced decline in both Utilities and Bonds, such action serves as advance notice for the entire stock market." It is of interest that as of last week, both of these Averages were breaking to fresh bear market lows.

GAUGES: The 30-week moving average of the D-J Industrial Average is often referred to as the "investment line." It shows two things; first the average price that investors have been willing to pay for the blue-chip Dow stocks over the past 30 weeks, and second the trend of that average price (or to put it another way, the trend of blue-chip values). The 30-week average hit an all-time high of 955 on April 20, 1966; it has been dropping at a rate of about 3 points a week ever since. The latest reading finds the moving average at 940 and in a well defined declining trend. During the March-April rise the Industrial Average touched the moving average, faltered (see chart 1), then turned down to render a primary bear signal (May 5). I consider the moving average to be in a bearish trend now, and the current 940 level should constitute a prime resistance point to any advance. Normally, the moving average will continue to decline through the major part of a primary bear market, although it may be approached and "tested" repeatedly as the bear market progresses. On May 7 the Industrials plunged 86 points below the moving average; this was the greatest span between the Dow and its moving average yet to be seen in this bear market.

In April net debit balances (margin accounts) rose \$191 million, thereby pushing total margins to \$5.8 billion, highest level in history. During that period the Industrials advanced to a bear market rally high (April 21) of 954.73. But there the movement faded. The rally featured wildly speculative moves in the glamour stocks, and my interpretation of the situation is that margins were extended heavily by speculators as they assumed large positions in these high-flying issues. But the advance fizzled and died with the D-J Averages well below their February highs, following which heavy selling pressure came into the market. Thus it would seem that many of these speculators are still sitting with heavy positions (many of them showing paper losses). Until proved otherwise, I consider that these speculators are trapped with large positions within a primary bear market.

The odd-lotters have been buying on balances all through this bear market so far. This is in contrast with their action during the decline of 1965 (at which time they sold steadily). Thus, the public has not taken the bear signal seriously, nor has it been scared by the 131 point drop of February to May. The public seems to consider the whole bear market decline as an opportunity to purchase stocks at increasingly attractive prices. This type of reaction on the part of the public in general, should be considered bearish.

The total short interest is probably now around 10 million shares. In late May and early June we witnessed a number of 4 to 5 million share (volume) days, which means that for a time the short interest ratio rose to over 2.0. This is ordinarily a bullish manifestation, and if this were a bull market I would consider the ratio a very bullish factor. However, in a bear market much less credence should be given to the short interest ratio. Few analysts today have had any experience interpreting the ratio in a bear market. During a bull market the ratio is important because it is a gauge of the relative degree to which the market is "sold-out." But in a bear market much more caution must be given to the concept of a sold-out market. During 1929-32 the Dow cut itself in half many times during vicious (single) bear legs. We can only imagine how sold-out the market must have appeared during each one of these crashes. Yet it must be remembered that bear markets can produce massive over-solds even while the Averages probe lower levels. Over-sold conditions in bear markets tend to be severe, while over-bought conditions within bear markets tend to be mild.

QUESTION: Where should one keep his money during a bear market? Are bonds all right?

ANSWER: In a bear market there is one overriding principle which should guide all investors, and that principle is safety. For a number of reasons (which include safety and negotiability) I have recommended that subscribers keep most of their money in 91-day U.S. Treasury bills. The response to this advice has been a bit strange. I believe that if I asked subscribers to take a position in General Motors, I would receive at least twenty letters asking if General Mills or General Foods or General Telephone would not be just as good. That seems to be what is occurring with my Treasury bill suggestion.

So here goes. Why aren't corporate bonds as good as Treasury bills? Some bonds may be, but most bonds mature over the longer term, and with the trend of the bond market still down, the bond holder runs the risk of being "locked in" when he needs his money. Also, most bonds do not compare in quality with Treasury bills. So that although many bonds may yield more than the current approximate 4.6% of Treasury bills, they lack the negotiability feature, and they will not hold up as well in the face of rising interest rates.

How about Municipal bonds with tax-free features? A tax-free Municipal will yield the equivalent of 6% in the 50% tax bracket. But Municipals can nevertheless be subject to the same problems as Corporates during a bear market in bonds. Municipals enjoy the full taxing power of whatever government unit issues them. But it should be remembered that since 1945 while Federal debt has risen 20%, state and local debt has risen 450%. It is no secret that many cities and municipalities are now heavily over-extended. In the event of a sharp drop in national income, these cities and municipalities could have a difficult time meeting their obligations.

In May, 1934, the Municipal Bankruptcy Act was passed permitting government units to petition the federal courts to approve plans for readjustment of their debts providing 51% of the bond holders agreed. State and local taxes, however, were quite small in 1934, even in relation to individual income. That simply is not the case today.

How about the banks and savings & loan associations? This is such a complicated question that I am just going to say that the majority of these institutions would probably weather a storm. The problems of the S & L's is well known, and how they would fare in a liquidity crisis is anyone's guess. Which takes us to the insurance factor. Many banks and S & L's offer insurance up to \$10,000 backed by a federal agency. How good is this insurance? Nobody knows, for it has never been really tested. But since the insurance is guaranteed by the U.S. Government, isn't the insurance feature of these institutions ultimately as good as the power of the U.S. Government. The answer is yes, but one problem could come in the area of the insurance pay-off. Assuming a subscriber was caught in a failing institution and it remained for the insurance policy to pay off, such action could take time. It could take time in just that period when the investor wanted his money badly. Which, in all, is my way of saying "why be half safe" or why be 90% safe? Why not play it as safely as possible with Treasury bills. I realize that this is a very cursory and hasty discussion of the potential drawbacks of the banks and S & L's, but it gets to the heart of the matter. In a bear market I want to eliminate as many possible problems and pitfalls as possible, and I think the best way to do it is with Treasury bills.

What about utility stocks, preferred stocks and defensive stocks? I throw them all in the same category. During a bear market, all stocks will tend to move lower, although the reasons for their decline may differ. Ironically, in a bear market the best quality shares may go lower simply because there is a market for them, and their owners throw them in because of the pressing need for cash. The need for money can drive a market down. This is a fact which few of today's generation can believe, but I have before me a page of the stock quotes on July 8, 1932 (the low day of the great 1929-32 bear market). The volume leader that day was American Telephone which closed down 2 points at 72 1/8. Remember, the then famous \$9 dividend had never been cut. People were selling telephone (it then yielded 12.5%) for one big reason, they needed the money, and telephone still enjoyed an active market.

FOREIGN MARKETS: Foreign stock averages are not doing well at present. Commenting upon this, Stock Exchange executive Henri Carpenter (Brussels) provided this explanation last week: "When New York is booming, we're stable. When New York is stable, we're doing bad. And when New York is doing bad, we're doing very bad. Therefore, we're doing very bad right now."

This week of the 12 foreign indices shown in Barron's, 7 were at or near lows for the year. On a trend basis (see accompanying chart), all foreign indices with the exception of Britain and Japan were in well defined downtrends. European production indexes are beginning to level off, and high interest rates are squeezing most European economies. With a huge mass of Certificates of Deposit falling due this month and next, large U.S. banks are coming into the European markets for Eurodollars (via the C/D route). This renewed sopping up of funds is calculated to run interest rates even higher in Europe. For comparison purposes, many European short-term Government maturities (comparable to our Treasury bills) are now yielding 6% and 7%. It should be remembered that at 6% interest, capital doubles every 12 years.

STOCKS: The average yield on the D-J Utility Average is about 4%, and it is probable that a better case can be made for investing in Utility stocks at this time than in any other group. Yet last week that Average broke to its lowest level since the first quarter of 1963. I want to stress again that a falling Utility Average (historically) has never provided the basis for a good investment climate. The two charts included are simply typical of most Utility stocks at this time.

(Charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas).

